

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES BOARD

IN RE: QWEST CORPORATION, f/k/a U S WEST COMMUNICATIONS, INC.	DOCKET NO. RPU-00-1 (TF-00-64)
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FINAL DECISION AND ORDER

(Issued January 11, 2001)

PROCEDURAL HISTORY

On March 15, 2000, Qwest Corporation, f/k/a U S WEST Communications, Inc. (Qwest), filed a proposed tariff identified as TF-00-64 in which Qwest proposes to deaverage its wholesale and retail rates in Iowa. Pursuant to rules adopted by the Federal Communications Commission (FCC), state public utility commissions are required to establish geographically deaveraged rates for unbundled network elements (UNEs) (Qwest's "wholesale" rates) by May 1, 2000¹. See 47 C.F.R. § 51.507(f). Qwest asserts that wholesale and retail rates should be deaveraged at the same time, using the same rate group structure, to avoid pricing anomalies and disparities.

¹ On April 26, 2000, the Board filed a petition for a temporary waiver of the May 1, 2000, deadline, seeking an extension to December 31, 2000, see In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, *Petition of the Iowa Utilities Board for Temporary Waiver*, CCB/CPD No. 00-15, at 1-2. The Board's petition was granted by order released July 13, 2000. During the course of this docket, however, the parties requested and received multiple extensions of time, with the result that the Board was unable to issue this final decision and order by December 31, 2000. Accordingly, on December 19, 2001, the Board filed a petition for a limited additional extension of time, to January 23, 2001. As of the writing of this order, the FCC has not ruled on the Board's second petition.

Qwest proposes deaveraging the unbundled loop UNE and certain retail rates into three geographic zones, or rate groups, as described in its proposal. Generally, Qwest proposes that loop prices and certain retail rates be decreased in urban areas and increased in rural areas; the filing as a whole is revenue-neutral, such that the projected revenue increases and decreases approximately offset one another.

On April 3, 2000, Goldfield Access Network, L.C. (Goldfield), filed an objection to the Qwest tariff, arguing that Qwest's proposed tariff revisions are unjust and unreasonable in violation of Iowa Code § 476.8 and in violation of Sections 252 through 254 of the Federal Communications Act. Goldfield asked the Utilities Board (Board) to reject Qwest's tariff filing or, in the alternative, to suspend the tariff and set the matter for hearing. Goldfield also asked the Board to commence a new rule making proceeding to establish statewide rules for deaveraging UNEs.

On April 4, 2000, the Consumer Advocate Division of the Department of Justice (Consumer Advocate) filed an objection to TF-00-64 and a request for docketing. Consumer Advocate noted that Qwest provides retail service in Iowa pursuant to a price regulation plan authorized by Iowa Code § 476.97 (1999) and approved by the Board on September 28, 1999. Qwest provides UNEs at rates established in proceedings conducted pursuant to Iowa Code § 476.101(4)"a" and 199 IAC 38.4. Consumer Advocate argued that Qwest's price plan prohibits some of the proposed retail price increases in TF-00-64. Consumer Advocate also argued that Qwest has failed to demonstrate its proposed wholesale costing methodology complies with applicable federal law. Accordingly, Consumer Advocate asked the

Board to docket TF-00-64 as a formal contested case proceeding and establish a procedural schedule for resolution of the issues associated with the filing.

Also on April 4, 2000, AT&T Communications of the Midwest, Inc. (AT&T), filed an objection to Qwest's proposal and a request to docket the proposal for hearing. AT&T objected to Qwest's proposal to set permanent deaveraged wholesale rates. AT&T asked that the Board docket the Qwest filing, allow the proposed wholesale rates to become effective as interim rates, subject to refund, and allow AT&T to participate as a party in this case.

On April 12, 2000, Qwest filed a response to the Consumer Advocate, AT&T, and Goldfield objections, arguing that some of the issues raised could best be resolved by docketing the filing as a formal proceeding and hearing evidence and argument from the parties. The Board agreed and, on April 14, 2000, issued an order docketing the tariffs as a formal proceeding identified as Docket No. RPU-00-1, establishing a procedural schedule, and granting intervention to AT&T and Goldfield. The Board did not, at that time, decide the issue raised by Consumer Advocate regarding the possible effect of Qwest's price regulation plan on the proposed retail price changes. Because the issue was primarily a legal one, the Board treated Consumer Advocate's objection on this issue as a motion to dismiss and set a briefing schedule.

On May 16, 2000, the Board issued an order granting intervention to McLeodUSA Telecommunications Services, Inc. (McLeod), Crystal Communications, Inc. (Crystal), and Rhythms Links Inc. (Rhythms).

On May 26, 2000, the Board issued an order directing Qwest to file a revised UNE pricing proposal reflecting the sale by Qwest of 32 Iowa exchanges to Citizens Telecommunications of Iowa, Inc. (Citizens), as approved by the Board in Docket No. SPU-99-31. Qwest was ordered to file the information on or before June 9, 2000.

On May 31, 2000, after receiving and considering the briefs filed by the parties concerning the possible effect of Qwest's price regulation plan on Qwest's proposed retail rate changes, the Board issued an order overruling Consumer Advocate's objection. The Board found that Qwest's price regulation plan permits, but does not require, retail rate design changes in connection with geographic deaveraging of UNEs.

On June 6, 2000, Qwest filed a motion for additional time to provide information regarding the sale of certain exchanges to Citizens. On June 22, 2000, the Board granted Qwest's motion. In the same order, the Board gave the parties notice of its intent to consider in this docket all issues remanded to the Board by order of the United States District Court for the Southern District of Iowa in U S WEST Communications, Inc., v. Thoms, et al., Civil No. 97-CV-70082. That court's order directed the Board to reconsider several issues from an earlier proceeding in which the Board established Qwest's existing UNE rates, including the FCC's requirement that the Board use TELRIC methodology to set UNE prices. The Board proposed to consider all of the remanded issues in this docket.

Consumer Advocate, AT&T, Goldfield, and Crystal filed objections to the Board's order, arguing that the limited time available to the Board to complete

geographic deaveraging of Qwest's UNE rates made consideration of these other issues in this docket impossible. Then, on July 18, 2000, the United States Court of Appeals for the Eighth Circuit issued a decision in Iowa Utilities Board, et al., v. Federal Communications Comm'n and United States of America, No. 96-3321 (and consolidated cases). This was not the same case as the U S West remand, but many of the issues were related. Among other things, the Eighth Circuit's decision vacated the FCC's TELRIC rules.

The Board considered the circumstances described above and the nature of the record made to date and concluded that the best available course of action was to limit the wholesale issues in this docket to setting geographically-deaveraged UNE rates based upon the cost studies used in Docket No. RPU-96-9, the docket in which the Board set Qwest's existing averaged UNE rates. Accordingly, on August 2, 2000, the Board issued an order sustaining the objections filed by AT&T and Consumer Advocate, as joined in by McLeod, Goldfield, and Crystal, and stating that the issue in this docket is how the Board should deaverage UNE rates based upon the cost studies used in Docket No. RPU-96-9. The other issues remanded to the Board by the United States District Court were left to future proceedings, if necessary.

The hearing for cross-examination of all prefiled testimony commenced on October 9, 2000, and continued through October 11, 2000. The parties filed initial post-hearing briefs on November 6, 2000, and reply briefs on November 13, 2000.

UNE RATE DEAVERAGING

The first issue in this docket is UNE deaveraging. The relevant FCC regulation, 47 U.S.C. § 51.507(f), provides:

- (f) State commissions shall establish different rates for elements in at least three defined geographic areas within the state to reflect geographic cost differences.
 - (1) To establish geographically-deaveraged rates, state commissions may use existing density-related zone pricing plans described in Sec. 69.123 of this chapter, or other such cost-related zone plans established pursuant to state law.
 - (2) In states not using such existing plans, state commissions must create a minimum of three cost-related rate zones.

Because Iowa does not use density zone pricing plans for special access and switched transport, the Board must create a minimum of three cost-related rate zones for UNEs with costs that vary on a geographic basis.

UNE deaveraging presents various subissues, specifically, which UNEs should be deaveraged, how many deaveraged zones should be created, and how should those zones be defined. The Board will address these subissues in turn.

1. Which UNEs should be deaveraged?

Qwest argues that only the UNE loop should be deaveraged in this docket. Qwest asserts that AT&T, Consumer Advocate, and almost every other state in the Qwest region agree with Qwest's position on this issue. (Tr. 250-52.) McLeod disagrees, but (according to Qwest) offers no evidence for deaveraging other UNEs. Qwest presents evidence that switching costs vary more by switch vendor than by

geography and that switching and transport UNEs cannot be deaveraged using the model that is the basis of this case. (Tr. 21, 79-82.) Qwest also offered testimony that transport costs are relatively low compared to other UNEs, so the administrative expense necessary to deaverage transport rates is not justified by the results. (Tr. 81-82.) According to Qwest, McLeod presents nothing to dispute this evidence. (Tr. 599-600.) Therefore, Qwest concludes it should not be required to deaverage switching or transport or to present additional studies in this proceeding.

Consumer Advocate and AT&T agree that loops are the only UNEs that should be deaveraged in this proceeding. However, both appear to consider loop deaveraging as a first step that does not foreclose deaveraging other UNEs in future proceedings. (Consumer Advocate Initial Brief at 4; AT&T Initial Brief at 1, 3-4.)

McLeod agrees that loops should be deaveraged, but argues that Qwest should also be required to deaverage transport and switching or, at minimum, to submit cost studies showing that transport and switching costs do not vary significantly according to geography. McLeod argues that shared transport costs should be lower in urban areas due to shorter distances between switches, while dedicated transport costs should be lower in urban areas due to use of higher-capacity SONET rings. (Tr. 550-51.) McLeod asserts the burden should be on Qwest to show that these geographic differences are not significant, if that is what Qwest believes, although McLeod notes that Qwest's own witness shows otherwise.

Qwest witness Brigham admits that Qwest has cost models that can demonstrate whether transport and switching costs vary by geography (Tr. 159-68)

and that Qwest has provided this information in other states. (Tr. 250-52.) Qwest used these models in preparing its TSLRIC cost studies in this proceeding. (Tr. 168-69, 176-77, 181, 610-12.) McLeod believes these models, if filed in Iowa, would provide useful information regarding the manner in which transport and switching vary with geography.

The Board finds it is reasonable to limit UNE deaveraging to the loop element at this time. The burden is on Qwest to propose deaveraged prices for all UNEs that have significant geographic cost differences, see 47 C.F.R. § 51.507(f). Qwest offered testimony that the variability in switching costs is more affected by non-geographic factors, such as switch vendor, than by geography. (Tr. 80-1.) McLeod had the opportunity to refute this evidence and did not. Qwest's testimony is sufficient to meet Qwest's burden on this issue, at least in the absence of contrary evidence.

Qwest also offered evidence regarding the need to deaverage shared and common transport. Qwest acknowledges there are geographic cost differences in transport, but testified these differences cannot be reflected in the Hatfield 3.1A model used for deaveraging in this docket. (Tr. 81-2.) Qwest also argued that the administrative costs associated with deaveraging transport costs are not justified by the resulting benefits; transport costs are a relatively small part of total UNE costs, so deaveraging would have only a slight impact on overall CLEC costs. However, Qwest does not provide any specific cost information to support its argument.

In the limited context of this particular case, the Board finds that the benefit offered by deaveraging transport UNEs is outweighed by the administrative costs. The parties all agreed that this case should be conducted on the basis of the cost record and the Hatfield 3.1A model used in Docket No. RPU-96-9, in order to permit completion of the case within the allowed time frame. This was a reasonable approach to this docket and the Board approved it, although it was not the Board's original preference. The Hatfield model does not reflect geographic differences in transport costs. (Tr. 81-2.) Thus, one of the consequences of this abbreviated approach to this docket is that the agreed-upon model does not produce all of the results that may be desired by some parties. While it would be possible to order special studies for the transport element, McLeod has not established any basis for singling out this one element for special treatment and the Board will not extend this docket by requiring further studies. The Board will not require that Qwest file special studies for geographic deaveraging of transport costs in this docket. However, this does not foreclose the possibility of deaveraging transport costs, or any other UNE elements, in any future UNE price proceedings.

2. How many deaveraged pricing zones should be created and how should they be defined?

The parties offer at least five different deaveraging proposals for the UNE loop, with 3, 5, 6, or 7 zones. Qwest proposes three zones, the minimum required by the FCC rule. Qwest asserts that more than three zones would add complexity with little benefit and notes that most of the states in Qwest's region have established only three zones. (Tr. 766, 780.)

Qwest argues that the three zones should be defined by a combination of cost factors and “communities of interest,” with a low-rate zone consisting of all wire centers that fall within the Metropolitan Statistical Areas (MSAs) of Cedar Rapids, Davenport, Des Moines, Dubuque, Iowa City, Sioux City, and Waterloo; a second zone defined as non-MSA wire centers with 5,000 lines or more; and a high-cost zone defined as non-MSA wire centers serving fewer than 5,000 lines. Qwest argues the communities of interest approach is logical, objective, minimizes customer confusion, and continues traditional rate design by minimizing wholesale rate differentials among similarly-situated customers in the same local calling area. If retail rates tend to follow wholesale rates in each wire center, as Qwest believes they will, then pure cost-based deaveraging would result in customers in the same MSA paying different retail rates based on the wire center from which they are served, creating a “rate anomaly.” (Tr. 295-96, 298-300, 313-14, 807-08, 851-53.) Qwest argues its approach adequately reflects cost differences between urban and rural customers and is easy to implement and administer.

AT&T provides a three-zone option, but proposes deaveraging UNE loop costs into five zones. AT&T argues that five zones will more closely reflect actual loop costs in each exchange with a minimal increase in implementation costs. AT&T also states that an increase to six or seven zones would not significantly increase implementation costs. (Tr. 777.)

AT&T argues against Qwest’s communities of interest approach, offering proposed rate zones grouped solely by loop cost. AT&T believes deaveraging based

solely on cost will best promote efficient competition by encouraging CLECs to make appropriate long-term decisions between purchasing UNEs and building their own facilities. AT&T's proposal sorts wire centers by average loop cost and then groups them into three zones to minimize the sum of the weighted average percent deviations from average zone loop costs. AT&T then divides each of zones 1 and 2 in half, using what AT&T calls "natural break points." The result is five zones with no overlaps and minimized cost ranges within each zone. By comparison, Qwest's approach produces a relatively wide range of loop costs within each zone; zone 1, for example, includes wire centers with average loop costs from \$13.99 to \$62.65, because the MSAs include low- and high-cost rate centers. (Tr. 718, Ex. RHB-2.)

AT&T also argues that Qwest's definition of zones 2 and 3, based upon number of lines served, is at best a proxy for cost, an unnecessary distortion when cost information is available. (Tr. 720.)

McLeod favors AT&T's cost-based method over Qwest's communities of interest approach. McLeod argues that Qwest's method groups wire centers by geography and switch size, rather than cost. (Tr. 715-20, 732-34.) McLeod also argues Qwest's proposal is inconsistent, relying upon communities of interest for zone 1 but ignoring this factor for zones 2 and 3.

Goldfield and Hickory Tech argue that AT&T's five zones should be increased to at least six zones to more closely match UNE prices with costs. This can be accomplished by splitting AT&T's zone five into two zones, reducing the number of

exchanges in the highest-cost zone. Goldfield and Hickory Tech also offered a seven-zone alternative, based on a three-way split of AT&T's zone five.

The Board finds that the purpose of UNE deaveraging is to encourage efficient, cost-based competition, a purpose that will be better served by a cost-based definition of UNE pricing zones. Qwest attempts to justify its proposal with the argument that its method will be more understandable to customers, but that argument rests upon the assumption that CLECs will design retail rates within each community based almost entirely upon Qwest's wholesale UNE rates, ignoring the fact that CLECs may choose to use a mix of resale, UNEs, and their own facilities. It is more likely Qwest's wholesale UNE rates will be only one of many factors in a CLEC's pricing decisions; other factors might include, for example, a CLEC's advertising campaign, its market entry strategy, and the costs it will incur to install its own facilities in different parts of any given exchange. There is no necessary, direct connection between Qwest's UNE prices and a CLEC's retail rates to any particular customer, so Qwest's concerns for retail customer confusion as a result of varying UNE prices within a single metropolitan area are not persuasive. The Board will reject Qwest's communities-of-interest approach and adopt a cost-based methodology.

The Board finds that UNE loop rates in Iowa should be deaveraged into three zones using a modified version of AT&T's three-zone, cost-based method. Three zones is sufficient to meet the FCC requirement for deaveraged UNE rates; it minimizes the administrative costs associated with tracking deaveraged zones; and it

is consistent with the action taken by most of the states in the Qwest region. The arguments offered in support of using 5, 6, or 7 zones are not persuasive. The parties advocating a greater number of zones claim the result will provide more precision and better cost signals, but they have not shown that the claimed improvement in precision will result in any tangible public benefit. The Board has already rejected the communities-of-interest approach because it is unlikely CLECs will set their retail rates primarily to reflect underlying UNE loop pricing differences; the same reasoning leads to the conclusion that a multiplicity of zones will not be directly reflected in CLEC rates, either. Thus, the extra administrative costs associated with a greater number of zones are not offset by any demonstrated benefits. The Board concludes that three zones offer the best cost-benefit balance.

AT&T's three-zone calculation was a strictly mathematical approach, minimizing the sum of the weighted average percent deviations from average zone loop costs within each zone. This resulted in a division between zones 2 and 3 of \$22. The Board believes AT&T's mathematical approach can be improved by the exercise of informed judgment, redefining the division between zones 2 and 3 as \$26, in order to promote and encourage the development of competition in telecommunications markets in a manner consistent with Iowa Code § 476.95(2).

The record in this case reveals that, to date, CLECs have not used Qwest's UNE loops as their primary means of providing competitive retail telecommunications services in Iowa. The total number of UNE loops sold in Iowa is not large, when compared to the potential. Moreover, many of the UNE loops sold to date have been

purchased in relatively small exchanges that, under the AT&T three-zone deaveraging approach, would be in zone 3. This would cause UNE loop costs in these exchanges to increase by as much as 40 or 50 percent, which would make UNE loops an uneconomic choice for competing in these smaller exchanges, effectively terminating a significant share of the existing use of UNE loops. That action would be inconsistent with state policy, as defined in § 476.95(2). That statute provides that “[i]n rendering decisions with respect to regulation of telecommunications companies, the Board shall consider the effects of its decisions on competition in telecommunications markets and, to the extent reasonable and lawful, shall act to further the development of competition in those markets.” Clearly, significantly increasing prices for UNE loops in exchanges where they are already being purchased would not “further the development of competition in those markets;” on the contrary, it would most likely destroy the competition that exists in those markets.

By redefining the division between zones 2 and 3 to move the exchanges in which UNE loops are being purchased from zone 3 to zone 2, the Board can avoid destroying the existing competition and further the development of that competition. This is best accomplished by changing the division between the zone 2 and zone 3 exchanges from \$22 to \$26. The effect is to decrease the UNE loop rate in the exchanges where UNE loops are currently being purchased, albeit at the cost of increasing the UNE loop rate in the highest-cost exchanges. However, no CLEC purchased any significant number of UNE loops in those highest-cost exchanges

when the loop rate was \$20.15; the Board will not sacrifice the existing UNE-loop-based competition in order to pursue potential competition that may never develop.

3. Should the exchanges being sold to Citizens be included in the calculation of deaveraged UNE prices?

The final issue in the UNE section of this order is whether the exchanges that Qwest is selling to Citizens should be included in the calculation of deaveraged UNE loop prices. In Docket No. SPU-99-31, the Board approved Qwest's request to sell 32 Iowa exchanges to Citizens. However, that transaction has not yet closed; Qwest anticipates closing sometime in January 2001. (Tr. 140-41.) Because these exchanges are relatively high-cost exchanges, if they are included in the calculation of Qwest's deaveraged UNE loop rates the resulting prices will be somewhat higher than they would be if the Citizens exchanges are excluded.

The Board could require that Qwest file one set of deaveraged UNE prices including the exchanges that are being sold to Citizens, then file a second set of prices after the transaction is closed. However, no useful purpose would be served by requiring two UNE price changes in such a short time period. Moreover, it is likely the transaction will close during the time the compliance tariffs are being prepared, filed, and reviewed by the Board, so any rates that included the Citizens exchanges would probably never be effective; they would be superseded before they were used. Instead of requiring such an exercise, the Board will require that Qwest file its deaveraged UNE prices based on the expected status of the Citizens transaction as of the proposed effective date of the compliance tariffs. The Board will give Qwest 45 days to prepare and file its compliance tariffs and the review process will require

an additional 30 days; thus, the compliance tariffs will not be effective before late March or early April 2001. The Board expects that the Citizens sale will have closed by that date.

RETAIL RATE ISSUES - INTRODUCTION

Qwest proposes to rebalance its retail rates at the same time as it deaverages its wholesale prices. Qwest's proposal would increase residential and business line rates in high-cost wire centers with offsetting decreases in other business rates, making the overall changes revenue neutral. This proposal has generated a number of issues, including the effect of Qwest's existing price regulation plan on the Board's authority to approve retail rate changes and the degree to which retail rate rebalancing in this docket is consistent with public policy. The Board concludes that Qwest's price regulation plan and the record in this case permit redesign of Qwest's business retail rates that are "basic communications services" using the loop, but redesign of Qwest's other rates in this docket is not permitted under the statute and Qwest's price regulation plan.

1. Are retail rate changes permitted under Iowa law and the price regulation plan?

A. Summary

Consumer Advocate and McLeod argue that Qwest's proposed retail rate changes are not permitted under Iowa law, specifically the terms and conditions of Iowa Code § 476.97 and Qwest's price regulation plan. These parties argue that

Qwest has not shown the changes to be the result of an “exogenous factor” and that the statute prohibits this change.

Qwest responds that the Board, in orders issued in other proceedings, expressly preserved the possibility of rebalancing retail rates at the time UNEs are deaveraged. Qwest also argues it has provided sufficient evidence to establish that UNE deaveraging is an exogenous factor.

The Board’s actions when it approved Qwest’s price regulation plan were intended to preserve the option of retail rate rebalancing at the time of UNE deaveraging, but that option was only to be exercised if the prevailing facts supported it. Moreover, while the language the Board added to the price plan preserved the option, that language does not change the requirements of § 476.97, and Qwest is still required to show that the retail rate changes are required due to exogenous factors beyond the control of the company, resulting in changes in revenue, investment, and expenses. Qwest offers evidence in this case that supports the conclusion that UNE deaveraging is an exogenous event as applied to basic business rates for services that use the loop, but not to residential rates, so the Board will only approve business rate redesign in this docket.

B. Consumer Advocate arguments

Consumer Advocate argues that Qwest waived any claim it may have to retail rate rebalancing when it elected to commence its price regulation plan with an across-the-board 3 percent rate reduction, rather than a rate case in which rate design issues could have been properly litigated. (Consumer Advocate Init. br. at

15.) Consumer Advocate also argues that the FCC mandate is not an exogenous factor requiring retail rate rebalancing because the FCC rule does not apply to retail rates; it applies to wholesale (UNE) rates only. (Init. Br. at 9-11.) Thus, according to Consumer Advocate, the federal mandate by itself is not an exogenous factor affecting retail rates.

Consumer Advocate argues Qwest's retail rate proposal fails to fulfill the statutory requirements of § 476.97(3)"d", which requires that a price regulation plan must include a provision for:

d. Reflecting in rates any changes in revenues, expenses, and investment due to exogenous factors beyond the control of the local exchange carrier.

Consumer Advocate argues Qwest failed to present any evidence that there will be "any changes in revenues, expenses, or investment due to" UNE deaveraging. (Init. br. at 13-16.) In fact, Consumer Advocate argues, Qwest's witness admitted that UNE deaveraging will not have a direct impact on Qwest's revenues, expenses, and investment. (Tr. 399-400.) The witness testified only to the possibility of unspecified revenue impact if Qwest were to lose customers as a result of pricing anomalies, which might result in less revenue. (Id.)

Consumer Advocate also argues Qwest has failed to prove any connection between UNE deaveraging and the proposed retail rate changes, that is, that the proposed rates "reflect" UNE deaveraging. (Init. br. at 14-16.) According to Consumer Advocate, Qwest's unsubstantiated claims about the costs of providing

retail services were not tested in this case because no retail cost studies were provided. (Init. br. at 15.)

Next, Consumer Advocate argues the language the Board added to the price regulation plan does not permit redesign of Qwest's retail rates. (Init. br. at 16-21.)

The Board added the following paragraph to Section III.G of the plan:

The Board, after reasonable notice and opportunity for hearing, may prescribe proportional increases or decreases for appropriate [basic communications services] and [nonbasic communications services] to reflect in prices, changes in revenues, expenses, and investments, due to exogenous factors beyond the control of U S WEST.

Qwest's proposal raises some BCS rates and reduces others; thus, according to Consumer Advocate, it is not "proportional."

Next, Consumer Advocate argues that Iowa Code § 476.97(3)"a"(4) prohibits consideration of wholesale unbundling as an exogenous factor. (Init. br. at 17-19.) Consumer Advocate acknowledges the Board's May 31, 2000, order in this docket finding that this case is not a wholesale unbundling case under the Board's unbundling rules pursuant to Iowa Code § 476.97(3)"a"(4), but Consumer Advocate disagrees with that ruling and suggests the Board should reconsider it.

Consumer Advocate then argues that the price plan statute only permits retail rate changes to reflect underlying changes that are both "exogenous" and "beyond the control of the local exchange carrier." (Init. br. at 19-20.) While Consumer Advocate concedes the UNE deaveraging obligation is beyond Qwest's reasonable control, Consumer Advocate believes it is not exogenous to the price regulation plan,

because unbundling and price regulation originated in the same statute, at the same time.

Finally, in response to Qwest's argument that rate rebalancing is required to prevent arbitrage, Consumer Advocate argues that Qwest's proposal does not justify retail rate changes because the rates are not changed sufficiently to prevent the alleged problem. (Init. Br. at 21-22.) All that Qwest has proposed, according to Consumer Advocate, is a limited degree of residential vs. business rebalancing, which does little or nothing to address the high-cost vs. low-cost concerns Qwest is relying upon to justify its proposal.

C. McLeod arguments

McLeod argues that Qwest has not shown UNE deaveraging to be a qualifying exogenous factor, noting that the FCC rule requiring UNE deaveraging says nothing about retail rates and the language in Section III.G of Qwest's price plan says only that the Board "may" adjust rates for exogenous factors; it does not mandate that the Board make any such changes. (McLeod Init. br. at 9-10, Reply br. at 5-9.)

McLeod also argues that the Board's statements in its final decision and order in Docket No. RPU-96-9 do not compel retail rate rebalancing at this time. (Init. br. at 10-13.) In that order, the Board declined to set deaveraged UNE prices, saying (among other things) that wholesale deaveraging without retail rate rebalancing could lead to pricing arbitrage. McLeod argues that the Board's statement assumed conditions that have not occurred. Specifically, McLeod believes the Board's statement was predicated on a belief that facilities-based competition would grow

using UNEs, which has not happened to any significant degree. McLeod also argues that the concern for arbitrage is misplaced; to the extent UNE deaveraging encourages CLECs to purchase UNEs in urban areas and rely upon resale in rural areas, the Board should not be concerned. First, if the resale discount is set correctly, Qwest is not harmed by resale in rural areas, and second, the Board should not attempt to preserve the implicit subsidies from urban markets to rural, pursuant to state statute.

D. Qwest Arguments

Qwest relies on certain language from the Board order in Docket No. RPU-96-9, which states:

... the deaveraging of UNE prices without the simultaneous deaveraging of retail prices would create arbitrage opportunities that might undermine the goal of encouraging efficient competition.

(“Final Decision and Order,” Docket No. RPU-96-9, April 23, 1998, at p. 34.) (Qwest Reply Br. at 12-14.) Qwest also relies on the language in the Board order approving Qwest’s price regulation plan, in which the Board rejected Qwest’s proposed language providing for rate rebalancing and said:

The Board does recognize, however, that deaveraging of rates for unbundled network elements may occur during the term of the price plan. In addition, other competition-related changes may occur that will create a need for the Board to consider rate rebalancing changes. The Board will address this situation by adding the following additional paragraph to the exogenous factors provisions in Section III.G: [Additional language omitted].

(“Order Approving Settlement And Modifying Price Plan,” issued September 28, 1998, in Docket No. RPU-98-4, at pp. 10-11.) Finally, Qwest points to the language of the Board’s May 31, 2000, order in this docket, in which the Board ruled that UNE deaveraging “is an exogenous factor that permits consideration of changes to [Qwest’s] retail prices, as contemplated in the Board’s order approving the price plan.” (“Procedural Order,” Docket No. RPU-00-1, issued May 31, 2000, at p. 5.)

The gist of Qwest’s argument is simple: The Board amended Qwest’s price plan and added language to section III.G in order to preserve the ability to rebalance retail rates at the same time as UNE prices are deaveraged. Qwest believes this is consistent with its understanding of the Board’s arbitrage concerns, expressed in Docket No. RPU-96-9: Because UNE prices are now being deaveraged, retail rates should be rebalanced.

Qwest also argues it has offered evidence to show that rebalancing is warranted even under Consumer Advocate’s interpretation of the statute and the price regulation plan. (Reply Br. at 25-29.) Specifically, Qwest’s witness testified that if UNEs are deaveraged without retail rate changes, Qwest will be subject to rate arbitrage and CLECs will have a reduced incentive to enter rural markets. (Tr. 299, 505-06.) Qwest argues it would be left to serve high-cost areas at below-cost rates while losing customers in low-cost areas, resulting in revenue impacts sufficient to satisfy the statutory requirement of “changes in revenues.” (Reply br. at 16-17.)

In response to Consumer Advocate’s argument that the price plan only permits “proportional” changes in retail rates as a result of exogenous factors, Qwest argues

that Consumer Advocate's interpretation would mean there could never be a retail rate rebalancing case under price plan regulation, since rebalancing can never affect all rates in the same way. Instead, Qwest argues that the requirement of "proportional" changes means that all increases and decreases must be proportional, that is, that the changes must be revenue neutral. (Reply br. at 18.)

Finally, Qwest agrees with Consumer Advocate that its proposed retail rate changes are not entirely sufficient to prevent all rate arbitrage, but Qwest characterizes its proposal as an interim step toward fully cost-based retail rates which will address issues including, but not limited to, uneconomic arbitrage.

E. Analysis

In its earlier orders in this and other dockets quoted above, the Board intended to preserve the option of retail rate rebalancing in conjunction with UNE deaveraging, if and when the prevailing circumstances make it appropriate to do so. However, the Board did not mandate that rebalancing must accompany UNE deaveraging, and the statutory prerequisites for an exogenous factors case must still be satisfied before retail rates can be changed in a price plan. Qwest has offered some evidence to meet those prerequisites and show that the proposed retail rate changes are necessary to reflect any changes in revenues, expenses, and investment, as required by § 476.97(3)"d".

The record Qwest made in this proceeding is sufficient to provide a basis for a Board finding that, in the absence of retail rebalancing, UNE deaveraging will result in adverse changes in Qwest's revenues. This issue will be further discussed below.

Based upon that finding, the Board can approve business retail rate changes intended to prevent the damage before it occurs, rather than force Qwest to suffer revenue losses before remedial measures can be adopted².

2. Is redesign of Qwest's business rates necessary and consistent with the public interest?

A. QWEST ARGUMENTS

Qwest argues that deaveraging of UNE prices is inextricably linked to rebalancing of retail rates, arguing that the Board previously recognized this in its final order in Docket No. RPU-96-9, quoted above. Qwest believes that wholesale deaveraging without simultaneous rebalancing will create pricing anomalies and disincentives to growth of competition in rural exchanges, will not move prices closer to cost, and will create uneconomic arbitrage between wholesale prices and business retail rates, preventing Qwest from recovering its reasonable costs of providing regulated services.

Qwest argues its retail rate proposal maintains appropriate relationships between business retail and wholesale rates and provides a first step to adjust residential rates. Qwest's existing retail rates are based on a "value of service" concept, with lower rates in exchanges that have smaller calling areas (typically rural exchanges) and higher rates in larger exchanges with more expanded calling areas. This approach tends to result in rates in the high-cost zones below the rates in the

² In fact, it is in the public interest in this case to respond to the exogenous factor now, before Qwest has suffered harm. By addressing the problem now, the Board can make revenue-neutral changes to Qwest's retail rates to prevent loss. If the Board were to wait until after the loss occurred, then another set of issues would have to be litigated and decided: How much damage had been done and what steps would be necessary and appropriate to undo that damage. These difficult and contentious issues are obviated by proactive action in this docket.

low-cost zones. Qwest submits that value of service pricing may have been appropriate in the past to promote universal service in a monopoly environment, but it is inconsistent with the cost-based approach required in competitive markets.

Qwest's retail rate rebalancing proposal for business rates would decrease certain rates for selected business services with increased revenues from residential services. Qwest's proposal also lowers business rates, primarily in urban, lower-cost exchanges, and increases other business rates, primarily in rural, higher-cost exchanges.

Qwest describes its proposal for retail residential rates as modest and reasonable. Qwest proposes to set all residential rates at a single, statewide level of \$12.65 per month. This is the existing rate for customers in the lowest-cost exchanges, while flat-rate residential service in the higher-cost zones is currently priced at \$10.71 or \$11.68 per month. Qwest argues these increases will not harm universal service, particularly when the measured service option at \$7.21 per month would still be available.

B. Consumer Advocate arguments

Consumer Advocate argues that, while Qwest expresses concern for pricing anomalies and disparities, Qwest never identifies the proper relationship between wholesale prices and retail rates and never demonstrates how arbitrage concerns rise to the level of an "exogenous factor" that will permit retail rate changes under Qwest's price regulation plan. Specifically, Consumer Advocate argues Qwest failed to prove that there will be any changes in revenues, expenses, or investments due to

UNE deaveraging or that the proposed rates represent proportional increases in appropriate basic and nonbasic communications service rates.

Consumer Advocate also argues that Qwest's residential retail rate proposal fails to reflect its UNE deaveraging proposal. The deaveraging proposal includes three to five zones with no increase or decrease in wholesale revenues, while Qwest proposes only one statewide rate for residential service with an overall increase in residential class revenues. Business rates would reflect three zones, but would be lower overall. Thus, according to Consumer Advocate, Qwest's retail deaveraging proposal is really rate rebalancing between the residential and business customer classes. (Reply br. at 5.) UNE deaveraging does not justify increasing retail rates to one customer class for the benefit of another class, according to Consumer Advocate.

Finally, Consumer Advocate argues the evidence does not support Qwest's claim that its retail rate proposal moves retail rates toward cost, consistent with Iowa Code § 476.95, because Qwest did not file fully-distributed cost studies to prove that its existing residential retail rates are below cost.

C. Goldfield and Hickory Tech arguments

Goldfield and Hickory Tech argue Qwest's proposed retail and UNE rates would create an unfair price squeeze by increasing UNE loop prices in many exchanges without increasing retail rates by the same amount, thereby squeezing, and even eliminating, their margins. These parties oppose the proposed price

changes that would have a negative impact on competition in the high-cost exchanges.

D. Analysis

The first question is whether Qwest has established the existence of an exogenous factor that permits retail rate changes under the price regulation plan. Iowa Code § 476.97(3)"d" provides that a price regulation plan must include provisions for "[r]eflecting in rates any changes in revenues, expenses, and investment due to exogenous factors beyond the control of the local exchange carrier." Consumer Advocate argues UNE deaveraging is not an "exogenous factor" for price plan purposes because the UNE deaveraging obligation and the price plan option were adopted in the same legislation. The Board disagrees. Price plan regulation was adopted in House File 518 of the 1995 session of the Iowa General Assembly, while this UNE deaveraging proceeding is a result of FCC rules adopted pursuant to the federal Telecommunications Act of 1996, an item of legislation with similar goals to Iowa's statute. Iowa's House File 518 preceded the federal act by several months and the FCC rules by over a year. Moreover, the FCC rules were subsequently stayed pending judicial review, during which time the Board established Qwest's initial, averaged UNE prices and Qwest opted to enter into a price regulation plan. The UNE deaveraging rule was reinstated at a later date, on subsequent review. The Board finds that UNE deaveraging pursuant to FCC rule was not contemplated as a part of House File 518 and therefore can qualify as an "exogenous factor" for purposes of § 476.97(3)"d".

No party seriously contends that the UNE deaveraging requirement was within the control of Qwest; clearly, the FCC's adoption of a regulation requiring the use of three geographic zones for UNE pricing, and the subsequent affirmation of that rule by the reviewing court, was beyond the reasonable control of Qwest. Thus, this proceeding also fulfills the requirement that the exogenous factor must be beyond the control of the carrier, if that is separate from the "exogenous factor" requirement in the first place.

The remaining issue is whether UNE deaveraging will result in changes to Qwest's revenues, expenses, and investment, as required by Iowa Code § 476.97(3)"d". Qwest's evidence on this point is sufficient to justify redesign of some of Qwest's retail rates: In the absence of retail rate redesign, UNE deaveraging will create opportunities for uneconomic arbitrage that will adversely affect Qwest's revenues, which ultimately will affect its investment. If UNE prices in low-cost exchanges are decreased, but the business retail prices in those exchanges remain high, then CLECs will buy UNE loops in those low-cost exchanges to compete with Qwest's artificially high business retail rates. At the same time, Qwest must continue to serve customers in high-cost exchanges at rates that are low compared to the deaveraged UNE loop rate established in this docket. Or, as explained by Qwest witness Fitzsimmons:

Consider the case where wholesale and retail prices have been inconsistently deaveraged, resulting in "low" wholesale prices and "high" retail prices in the same geographic area. The buyers in the "high" priced market are retail customers. The buyers in the "low" priced market are CLECs. Retail customers cannot purchase wholesale UNEs; they can only

purchase retail services, either from the ILEC or from a CLEC. Because a CLEC can participate in both markets, it can purchase in the “low” priced wholesale market and sell in the “high” priced retail market; that is, it can act as an arbitrageur between the two markets.

(Tr. 505-06.) The result of such arbitrage would be that Qwest cannot compete in the lower-cost exchanges and would not have a reasonable opportunity to recover its costs and earn a fair rate of return in the higher-cost exchanges, all of which would have an impact on Qwest’s revenues.

This is only true for Qwest’s business customers. Qwest’s residential rates are currently below its UNE loop cost in every exchange, both before and after UNE deaveraging. This is the result of a variety of factors, primarily the fact that Qwest’s retail rates are set on the basis of embedded cost while its UNE prices are based on forward-looking cost. Even Qwest admits its embedded costs are lower than forward-looking in Iowa; a Qwest witness offered testimony the embedded cost of a loop is \$17, lower than the statewide average UNE loop price of \$20.15. (Tr. 59.) Qwest’s \$17 figure was contested by both Consumer Advocate witness Hunt and McLeod witness Ankum, and this record does not permit any determination regarding the actual embedded cost, but the fact remains that so long as Qwest’s embedded costs are lower than its forward-looking costs, at least some of its retail rates will be lower than its UNE prices, as appears to be the case with its residential rates.

Because of this pricing relationship, there is no opportunity for CLECs to purchase low-cost UNE loops to compete with a higher Qwest residential retail rate. Therefore, the Board concludes that, for purposes of Qwest’s price regulation plan

and Iowa Code § 476.97(3)"d", UNE deaveraging is an exogenous factor that can change Qwest's revenues, expenses, and investment only with respect to Qwest's business rates. Accordingly, only Qwest's business rates can be changed to reflect UNE deaveraging in this docket.

Moreover, the business rates subject to change in this docket are limited to basic communications services that rely upon the loop and are therefore directly affected by UNE loop deaveraging. Qwest proposed numerous changes in its business retail rates, including some services that are basic communications services (BCS) as defined in § 476.96 and some services that are nonbasic communications services (NCS). NCS rates that Qwest proposed to change in this docket include Custom Choice, Custom Choice – Main Line, Custom Choice – Additional Line, and Call Forwarding – Busy Line, Busy Line/Don't Answer, and Don't Answer – Expanded. However, the approved price regulation plan already gives Qwest substantial flexibility with respect to its NCS; Qwest can decrease NCS rates with what is effectively no more than an informational filing with the Board, and Qwest can increase NCS rates at any time, subject to certain overall limitations. Because Qwest already has the ability to adjust NCS prices as necessary, the Board will not address them further in this docket.

Further, some of the BCS rates that Qwest proposed to adjust in this docket are for services that are not primarily associated with the loop and are therefore not directly affected by UNE loop deaveraging. Basic business services for which Qwest proposed rate changes, but which are not directly affected by UNE loop deaveraging,

include DID Trunk Terminations, Network Access Registers, and Hunting. The rates for these services cannot be adjusted in this docket because the identified exogenous factor (deaveraging and the resulting arbitrage) will not affect these services.

This leaves the following business BCS rates proposed by Qwest as candidates for redesign: Business Flat, Business Flat – Additional Lines, Standby Line, PBX Trunks (in various forms), Public Access Lines (again, in various forms), ISDN, Centrex, 2-way/4-wire trunks, Inward DID for Call Transfer, and Switchnet 56. Each of these is a BCS that is primarily associated with the loop, the rate for which should therefore reflect the UNE loop price being set in this docket. In addition to the services proposed by Qwest for rate redesign in this proceeding, the Board will also order the deaveraging of Centrex Plus into the UNE zones approved by the Board. Centrex Plus is a BCS and is directly affected by UNE loop deaveraging. This is the first criterion Qwest should use in redesigning the eligible business BCS retail rates.

The second criterion to be applied in redesigning those business rates is that each basic business service or product using the loop should be deaveraged on a revenue-neutral basis for that particular service. In other words, it is not sufficient that business rates are redesigned so that the aggregate change is revenue neutral; each service category should be independently revenue neutral. Otherwise, the resulting changes would amount to redesign of the rate relationship between different services, which is not a type of change that is supported by UNE deaveraging as an

exogenous factor. The only permissible change is geographic deaveraging of each affected service, on a service-specific, revenue-neutral basis.

The third criterion to be applied in redesigning Qwest's business rates is that the rate increase to any particular customer should not exceed 20 percent. In Qwest's original proposal, the proposed increase for the vast majority of the services would have been no greater than 21 percent. The parties have litigated this case based upon that proposal and the Board will not change that limitation at this late stage in the proceedings.

The fourth, and final, criterion to be applied in redesigning Qwest's business rates is that the resulting rates for business flat rate services that include the loop should equal or exceed the deaveraged UNE loop price in the same zone. Thus, if the zone 3 UNE loop price is \$32.37 per month, the rate for flat-rate business service in zone 3 exchanges should be at least \$32.37 per month. This will reduce the incentive for pricing arbitrage for these business services.

The effect of applying these four criteria to the redesign of Qwest's basic business services will be to reduce Qwest's loop-based, BCS business rates in the low-cost exchanges (zone 1) and increase those rates in zone 3, the high-cost exchanges. This amounts to a reversal of the existing rate relationship, with the highest retail rates in the lowest-cost exchanges and the lowest retail rates in the highest-cost exchanges. The existing rates are a product of value of service pricing, as discussed previously, a regulatory policy that served an important purpose (promotion of universal service through subsidy of high-cost service areas) but that is

no longer the primary or sole public interest concern the Board must consider. The Iowa General Assembly has directed that the Board, in rendering its decisions with respect to regulation of telecommunications markets, "to the extent reasonable and lawful, shall act to further the development of competition in those markets." Iowa Code § 476.95(2). The General Assembly has also directed:

In order to encourage competition for all telecommunications services, the board should address issues relating to the movement of prices toward cost and the removal of subsidies in the existing price structure of the incumbent local exchange carrier.

Iowa Code § 476.95(3). Value of service pricing, with its implicit subsidies and rates that are inversely related to cost, is in conflict with both of these policies. It inhibits the development of competition in rural, high-cost exchanges by subsidizing Qwest's existing rates in those exchanges. In this docket, the restrictions of Iowa Code § 476.97(3)"d" only allow the Board to adjust loop-based basic business service rates, but in the long run it is likely that state policy and increasing competition will require changes in the design of Qwest's other rates, as well.

The existing record in this docket does not permit calculation of the precise rate changes that will result from this order. This business retail zones will change to match the deaveraged UNE zones, while residential retail zones will remain the same, but the precise changes are difficult to quantify. The world has not been static while this case was pending. For example, Qwest recently implemented changes under its price regulation plan; the changes were approved in Docket No. TF-00-250 (subject to rehearing). The resulting rate changes are not a part of this record, but

must be considered in the business retail rate redesign. Therefore, the Board will direct Qwest to prepare and file proposed compliance tariffs that redesign Qwest's business rates according to the four criteria described previously. The Board will also direct Qwest to work with Board staff and any of the parties who may be interested in the preparation of the compliance tariffs. The Board emphasizes that staff's involvement does not mean the Board will automatically approve the resulting compliance tariffs; when filed, they will be subject to review by the Board and to objection by the other parties to this proceeding. However, the Board believes that staff and party involvement in the development stage is likely to reduce the number of questions raised and issues presented by the compliance tariffs, when filed.

CONCLUSIONS OF LAW

The Board has jurisdiction of the parties and the subject matter of this proceeding pursuant to Iowa Code ch. 476 (1999) and 47 C.F.R. § 51.507(f).

FINDINGS OF FACT

1. It is reasonable to set geographically-deaveraged prices for the UNE loop in this docket, but not for the switching and transport UNEs.
2. It is reasonable to establish three geographic zones for the UNE loop, based upon the cost-based methodology proposed by AT&T, modified to redefine the division between zones 2 and 3 as \$26, rather than \$22.
3. It is reasonable to conclude that geographic deaveraging of UNE prices without redesign of Qwest's loop-based BCS business rates would create

opportunities for uneconomic arbitrage that will adversely affect Qwest's revenues and, ultimately, its investment.

4. It is reasonable to conclude that each basic business service or product using the loop should be deaveraged on a revenue-neutral basis for each particular service or product.

5. It is reasonable to conclude that any retail rate increases resulting from this docket should not exceed 20 percent.

6. It is reasonable to conclude that the redesigned rates for BCS business services that include the loop should equal or exceed the deaveraged UNE loop price in the same zone.

7. It is reasonable to conclude that the record in this case does not permit redesign of residential retail rates.

ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The proposed tariff filed by U S WEST Corporation, Inc., n/k/a Qwest Corporation, on March 15, 2000, and identified as TF-00-64 is declared to be unjust, unreasonable, and unlawful and is rejected.

2. On or before 45 days from the date of issuance of this order, Qwest shall file a revised proposed tariff setting forth deaveraged UNE loop prices and BCS business retail rates complying with the criteria adopted by the Board in this order. Qwest shall consult with Board staff in the preparation of these compliance tariffs and all parties shall be given a reasonable opportunity to participate in the preparation of

the compliance tariffs. When the compliance tariffs are filed, any party may file an objection to the compliance tariffs within 20 days of the date the tariffs are filed. If any such objections are filed, the Board will order such further proceedings as may be appropriate in the circumstances.

3. Motions and objections not previously granted or sustained are denied or overruled. Any argument in the briefs not specifically addressed in this order is rejected either as not supported by the evidence or as not being of sufficient persuasiveness to warrant comment.

UTILITIES BOARD

/s/ Allan T. Thoms

/s/ Susan J. Frye

ATTEST:

/s/ Judi K. Cooper

Acting Executive Secretary

/s/ Diane Munns

Dated at Des Moines, Iowa, this 11th day of January, 2001.